THE CORPORATE ENTITY AND THE INCOME TAX

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IN business, as in government, experts are ever on tap, with suggestions for the taxpayer upon which no Mephistopheles could improve. They offer to erect an impregnable fortress into which the tax collector cannot penetrate. Eager to escape thither, the taxpayer, who has been told on high authority that it is not even a patriotic duty to pay more than the legal minimum,[1] faithfully follows the paths indicated by his counsellors. The bricks and mortar of these fortresses consist of corporate entities, inter-company accounts, stock dividends and the like. But it often turns out that the resulting tax is paid without even the comfort of a patriotic duty well done.

In administering the Income Tax Law the treasury has refused the burden of advising taxpayers in advance of the adoption of a plan whether it will result in an increased or diminished tax.[2] Frequently the determination depends upon whether the law will respect the separate corporate personalities brought into being by the taxpayer, or as the judges say, will look "through form to substance" and disregard the existence of the corporate entity. Here is a field of law in which, as in so many others, predictability is highly desirable. Yet here too, judicial statesmanship plays the important role, to the confusion of the experts and the occasional unwilling patriotism of the taxpayer.

It has been pointed out that Congress itself frequently found it necessary, in enacting income tax legislation, to make special provisions disregarding the corporate entity.[3] These appear in regulations applicable to personal service corporations,[4] in requirements for consolidated returns from affiliated corporations,[5] and the penalties imposed upon corporations which accumulate unnecessary surplus to avoid surtaxes on

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1. Judge Learned Hand, Helvering v. Gregory, 69 F. (2d) 809, 810 (C. C. A. 2d, 1934).

2. VIII-1 Cum. Bull. 333; V-1 Cum. Bull. 131; III-2 Cum. Bull. 351; I-1 Cum. Bull. 400; 1 Cum. Bull. 310. But cf. U. S. Treas. Reg. 77, Art. 1281, where in a limited field the treasury has undertaken to advise taxpayers in advance of the adoption of a plan.

3. Ballantine, *Corporate Personality in Income Taxation* (1921) 34 HARV. L. REV. 573.

4. See Revenue Act of 1918, Sec. 218 (e), 40 STAT. 1070 (1919); Revenue Act of 1921, Sec. 218, 42 STAT. 245 (1921); Revenue Act of 1932, Sec. 115 (c), 47 STAT. 204, 26 U. S. C. A. § 3115 (1932); Revenue Act of 1934, Sec. 115 (e), P. L. No. 216, 73d Cong., 1st Sess. (1934).

5. Revenue Act of 1918, Sec. 240, 40 STAT. 1081 (1919); see also Revenue Act of 1926, Sec. 240, 44 STAT. 46, 26 U. S. C. A. § 993 (1926); and Revenue Act of 1928, Sec. 141, 45 STAT. 831, 26 U. S. C. A. § 2141 (1928).

the income of stockholders.[6] The problem we are here considering, however, does not involve the power of Congress to collect taxes in disregard of corporate entity, but is rather the problem of determining the intent of Congress with regard to corporate entities concerning which it has not spoken at all.

I

Judicial attempts to formulate principles to guide the treasury in collecting and the taxpayer in deciding whether to contest taxes of this sort have not been wanting. But as in the case of all standards of judgment, it is one thing to state a proposition and another to apply it to numerous and varying factual situations. First year law students are all familiar with the hardships encountered in isolating the reasonable man. Constitutional lawyers have long ago abandoned the effort to define "due process of law". These things we all know about. But lawyers are too prone to overlook the fact that, even in so theoretically routine a matter as collecting the income tax, "imponderables have weight".

The courts have freely recognized the difficulties involved in establishing a working rule to determine in what classes of cases the corporate entity will be disregarded in assessing the income tax. Judge Learned Hand, discussing this problem, tells us:

"If our law regarded a corporation as an association of individuals created for the purposes defined in their charter, whose extent was measured as we measure that of a consensual association, like a partnership, an unincorporated society, or a criminal conspiracy, the result would be simple. Such a corporation would be immanent in everything which was done in execution of its purposes. Or if we had the hardihood to adhere to the rigid convention of a corporation persona, in which, however empty a shell, all rights reside, and to which all duties attach, whatever the strain on our moral predilections, at least we should have a workable concept. As it is, our law has been baffled by the problem and has wavered between the two alternatives. Since we have no statutes of uses to execute the dry use, I have no great confidence that I can pick a certain path among the cases."[7]

Mr. Justice Holmes with customary sententious expression has offered a guide, which while it may not solve specific problems that arise, yet has the merit of presenting the issue in a form calculated to simplify analytic examination. He says:

"We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an

6. Revenue Act of 1934, Sec. 102, P. L. No. 216, 73d Cong., 1st Sess. (1934).
7. Proctor & Gamble Co. v. Newton, 289 Fed. 1013, 1015 (S. D. N. Y. 1923).

act is condemned as an evasion what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."[8]

To ascertain the locus of the line we must in many cases determine whether a particular corporation shall be regarded as a separate personality whose income can be taxed only to it and entirely to it or whether in the given case we shall disregard the fiction of the corporate personality in order to attach the corporation's income to other persons or allow them to deduct from their own income the corporate losses. The courts never weary of telling us that they "recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and the Income Tax Laws enacted thereunder".[9] But the corporate personality cannot be brushed aside as a mere form in all cases.

Mr. Justice McReynolds tells us that it is only "unusual cases"[10] that may require the disregard of the corporate form; and the Board of Tax Appeals, very early in its history, said that the "corporate entity will not be disregarded except in extraordinary circumstances."[11] Judge Learned Hand, although fully aware of the difficulties involved, has likewise offered a working principle for the determination of problems involving the corporate entity:

> "A corporation, stripped of its fictitious personality, is an association of persons mutually agreed upon the execution of more or less definitely expressed purposes, publicly registered as the law requires. In the case of industrial corporations, the personnel of the membership is an immaterial matter; the original members leave as they please and their substitutes enter merely by purchase. Even the number of the members changes from time to time. If so, it is the common purposes and their execution alone that determine the corporation, and whatever substantially changes these changes the corporation itself, and the rights of its stockholders."[12]

These expressions of principle can hardly be regarded as rules of thumb. No one of them by itself can offer any great help in the solution of specific problems. Perhaps a combination of all of these principles has a greater individual applicability, but in the main they must be regarded as justifications judicially worked out for results in particular cases.

Because in equity it frequently happens that courts will avoid injustice to litigants by lifting the corporate veil, it is commonly imagined

8. Bullen v. Wisconsin, 240 U. S. 625, 630 (1916).

9. United States v. Phellis, 257 U. S. 156, 168 (1921).

10. Burnet v. Commonwealth Improvement Co., 287 U. S. 415, 419 (1932).

11. Regal Shoe Co., 1 B. T. A. 896, 899 (1925).

12. United States v. Rockefeller, 274 Fed. 952, 955 (S. D. N. Y. 1921), aff'd 257 U. S. 176 (1921).

that the disregard of the corporate entity produces the larger tax collection. This is by no means always the fact. Frequently the greatest tax can be collected only by rigid adherence to the separate personality of corporations; and, as we shall have occasion to point out, some judges who are apparently guided by the principle that maximum taxation is the greatest good have oscillated between one position and another as the cause of the tax collector required.

The multitude of forms in which this problem makes its appearance on the judicial scene is limited only by the scope of the imaginative powers of the tax experts. The courts are constantly being confronted with apparently distinguishable situations and instances which are not quite like those that have gone before. In the end, the judges are avowedly baffled and find themselves with a rule always in parturition, never delivered.

Reorganization cases are in point. A reorganization occurs when stockholders receive securities of their own corporation or of a new corporation, in exchange for or in addition to their old securities.[13] The simplest form is the declaration of a stock dividend consisting of unissued stock of the dividend paying corporation. A stock dividend may also consist, however, of securities of another corporation which are owned by the dividend paying corporation. A reorganization may take place by the transfer of the assets of one corporation to another, and the distribution of the securities of the new corporation to the stockholders of the old either directly or by way of stock dividend. In all of these cases, the income tax problem is concerned with the determination of whether or not the securities received by the stockholder are taxable as income to him. In all of them, except in the case of the simple stock dividend, insistence upon the separate entity of the corporations involved makes the distribution of securities taxable income. In the stock dividend case, the Supreme Court exempted the securities from taxation both on constitutional and analytic grounds. In the other cases, the Supreme Court has not been consistent. On one occasion, in *Weiss v. Stearn*,[14] it held that where the assets of a corporation are transferred to a new corporation, and the stock of the new corporation is distributed to the stockholders of the old, no income taxable to the stockholder results. Here the court pointed out the essential identity between the new and the old corporation. In *Marr v. United States*,[15]

13. We are not here using the term "reorganization" in the technical sense in which it is defined in Section 112 (g) of the Revenue Act of 1934, P. L. No. 216, 73d Cong., 1st Sess. (1934), but rather, loosely, to describe a change in corporate structure.

14. 265 U. S. 242 (1924).

15. 268 U. S. 536 (1925).

however, and in *Cullinan v. Walker*,[16] the contrary result was reached. It has been said that *Weiss v. Stearn* was wrongly decided, but it has been cited by the Supreme Court and often followed by lower courts.[17] The truth is that the Supreme Court has set up two conflicting lines of decision resulting from its inability to arrive at a working rule with regard to the problem of the corporate entity.[18]

The same conflict is apparent in the lower courts, where the problem has produced conflicting decisions in the various circuits. Thus Judge Parker, writing for the Circuit Court of Appeals for the Fourth Circuit in *Western Maryland Railway Company v. Commissioner of Internal Revenue*,[19] held that a corporation taking over the assets of an old corporation may continue to deduct amortization of bonds sold at a discount by the former corporation on the theory of the identity of the two corporations. A different court in a different circuit held precisely the reverse in *Turner-Farber-Love Company v. Helvering*.[20] And still another circuit, in *United States v. Alpha Portland Cement Company*,[21] determined that the transfer of property of one corporation to another and the distribution of the stock of the new corporation to the stockholders of the old resulted in no income taxable to the old stockholders.

Brief writers would have no difficulty in building up a case for or against the taxation of such securities as income by the simple device of distinguishing all details of fact in opposing cases or by the more academic practice of denouncing contrary decisions as wrongly decided.

The disregard of the corporate entity in income tax cases involving the relations between parent and subsidiary corporations is generally supposed to be supported by two decisions of the Supreme Court rendered in 1918: *Southern Pacific Company v. Lowe*[22] and *Gulf Oil Corporation v. Lewellyn*.[23] In both cases the Court held that a dividend paid by a wholly owned subsidiary to the parent corporation out of earn-

16. 262 U. S. 134 (1923).

17. Bowers v. Lawyers Mortgage Co., 285 U. S. 182, 188 (1932); A-C Investment Ass'n v. Helvering, 68 F. (2d) 386, 390 (App. D. C. 1933); Burnet v. Kountze, 66 F. (2d) 141, 144 (C. C. A. 8th, 1933); Shreveport-El Dorado Pipe Line Co. v. McGrawl, 63 F. (2d) 202, 204 (C. C. A. 5th, 1933).

18. But cf. Note (1932) 80 U. OF PA. L. REV. 892, 898, and also Beale, *Stockholders and the Federal Income Tax* (1923) 37 HARV. L. REV. 1.

19. 33 F. (2d) 695, 698 (C. C. A. 4th, 1929): "It is instructive to note the many tax cases decided in recent years in which the courts have not hesitated to ignore corporate forms, and to decide the questions involved in the light of what the parties have actually done, rather than on the basis of the forms in which they have clothed their transactions."

20. 68 F. (2d) 416 (App. D. C. 1933).

21. 261 Fed. 339 (C. C. A. 3rd, 1919).

22. 247 U. S. 330 (1918).

23. 248 U. S. 71 (1918).

ings accrued before March, 1913, was not income of the parent corporation. The holding was not based on the proposition that the earnings accrued before March, 1913, the date when the Income Tax Law became effective, since the Supreme Court has also held that dividends paid in the regular course of business out of earnings accrued before that date are taxable to the stockholder.[24] The decisions were rather based upon the proposition that the parent and the subsidiary were not separate entities.[25] Lower courts have followed these decisions more faithfully than has the Supreme Court itself.[26] The Court, however, has apparently been aware of the fact that these cases establish no rule of general application, first, because they are by their express terms limited to the facts before it,[27] and secondly, because in spite of the decision taxing dividends paid out of earnings accrued before March, 1913, there seems to have been some hesitancy on the part of the Court to apply this rule to these cases. Moreover, the Supreme Court has departed from the notion that a wholly owned subsidiary is not a separate entity. This fact appears most strongly in the recent case of *Burnet v. Commonwealth Improvement Company*,[10] where the exchange of securities between a corporation and its sole stockholder was held to constitute a taxable transaction and where the court expressly distinguished and limited *Southern Pacific Company v. Lowe*.[22]

Another situation in which the recognition or disregard of the corporate entity presents a problem is found when one corporation leases property to another, with the rent payable directly to the stockholders of the lessor. While the courts do not have any difficulty in disregarding the corporate entity in this class of cases and have held that the sums paid to the stockholders may be regarded as income to the corporation and taxed to the corporation, they have nevertheless in practice permitted the avoidance of the tax by the holding that the stockholder who receives the rent is not answerable at all for the default of the corporation lessor in paying the tax even where all the assets of the corporation have been distributed to the stockholders.[28] By this process the tax is effectively

24. Lynch v. Hornby, 247 U. S. 339 (1918).

25. "While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control." Southern Pacific Co. v. Lowe, 247 U. S. 330, 337 (1918).

26. Kirby Lumber Co. v. United States, 44 F. (2d) 885 (Ct. Cl. 1930); Labrot v. Burnet, 57 F. (2d) 413 (App. D. C. 1932); H. H. Miller Industries Co. v. Commissioner of Internal Revenue, 61 F. (2d) 412 (C. C. A. 6th, 1932); Thorsen v. Commissioner of Internal Revenue, 65 F. (2d) 234 (C. C. A. 9th, 1933).

27. "The case turns upon its very peculiar facts, and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised." Southern Pacific Co. v. Lowe, 247 U. S. 330, 338 (1918).

28. Cf. Anderson v. Morris & Essex Rr. Co., 216 Fed. 83 (C. C. A. 2d, 1914), where

circumvented, for the corporation lessor having leased the property and provided for the payment of rent to the stockholders now distributes its assets among the stockholders, and while theoretically the court disregards the corporate entity and holds that the Commissioner is justified in assessing the tax against the lessor corporation, practically, the holding that he cannot follow the assets for the purpose of collection into the hands of the stockholders is equivalent to a determination that the stockholder and the corporation are in reality distinct juristic persons. And no attempt is made by the courts to explain these apparently incompatible holdings.

The recent effort of the Board of Tax Appeals in *George H. Chisholm*[29] to formulate a rule by which to determine whether a particular transaction is with a real juristic person or a phantom entity is all the more welcome in view of the failure of the courts to provide an even partially satisfactory guiding principle. The Board tells us that if a corporation is formed in the ordinary course of the taxpayer's business and for the purpose of serving the proper ends of its commercial activity, then the corporate entity should be respected; but that if the corporation is formed when the shadow of the tax hovers over the taxpayer and in a last minute attempt to avoid its blow, then the law will ignore the legal fiction of the corporation person. It is obvious that this looks in the direction of the motive of the taxpayer, so that if a corporation is organized for the express purpose of avoiding a tax liability, and cannot be justified as a normal business act, the corporate entity will be disregarded. But even this rule, which commends itself to reason, has not been adopted by the courts. The notion persists in many decisions that a pattern of

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the court, construing the excise tax of August 5, 1909, said at page 90: "The notion that a corporation is an artificial entity distinct from the members who compose it is a fiction of the law which the courts recognize for some purposes and disregard for others. Without going into the matter at length, it suffices to say that the fact that the lessee paid the rent, not to the corporate entity, but to the stockholders and bondholders, cannot prevent the act from applying to the money so paid if the other conditions of the act make its terms applicable. The fiction referred to cannot be permitted to accomplish a fraud upon the statute and an evasion of its obligations." Yet in this very case the corporation escaped the tax because it was no longer "doing business" within the meaning of the statute. In Rensselaer and Saratoga Rr. v. Irwin, 249 Fed. 726 (C. C. A. 2d, 1918), the court held that rent paid by the lessee to the stockholders of the lessor was corporate income of the lessor and could be taxed as such, but said at page 728: "We are not concerned with the questions how the plaintiff can pay the tax or how the Government is going to collect it." See also American Telegraph and Cable Co. v. United States, 61 Ct. Cl. 326 (1925), cert. denied 271 U. S. 660 (1926). And in Harwood v. Eaton, 68 F. (2d) 12 (C. C. A. 2d, 1933), it was specifically held that the owner of stock in a corporation is not liable as transferee for income taxes due from his corporation on account of rent paid directly to such stockholder pursuant to the lease. To the same effect see United States v. Western Union Telegraph Co., 50 F. (2d) 102 (C. C. A. 2d, 1931).

29. 29 B. T. A. 1334 (1934).

conduct mapped out by a taxpayer must be judged without regard to the motive which led to its adoption.[30]

Nevertheless, many courts, and the Board of Tax Appeals itself in earlier cases, seem to have been groping their way inarticulately toward some such rule. The corporate entity has been disregarded and additional income taxes imposed in a long line of cases, which, although they do not fall into any scientific classification, seem to have as a common denominator a certain transparency which reveals the taxpayers' unwillingness to be taxed, even where the motive is not definitely to evade taxation. The taxpayer in such cases usually produces reasons for his conduct which are quite independent of the tax law, but these reasons are in the main quite thin, and though they may perhaps explain, from the point of view of the courts they do not justify the avoidance of the tax liability.

The cases need but be collected to illustrate the point. Thus it was held that a corporate entity will be disregarded where the corporation was created merely for the purpose of passing title and receiving payment;[31] that a transfer of property by a corporation to two of its stockholders in order for them, rather than the corporation, to fulfill a contract to sell property does not avoid the tax to be paid by the corporation;[32] that a sale by a corporation to its president, who on the same day resold the property and divided the profits amongst its stockholders, does not relieve the corporation from the necessity of paying the tax on the profit;[33] that a corporation may not deduct a loss which it has suffered by the sale of securities to its stockholders for less than cost;[34] that the corporate entities will be disregarded where a liquidating corporation transfers its property to another corporation for the benefit of its stockholders.[35] In these and other cases, the courts using the most general

30. "We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes" Helvering v. Gregory, 69 F. (2d) 809, 810 (C. C. A. 2d, 1934). In the same case the Board of Tax Appeals below said: "As long as corporations are recognized before the law as if they were creatures of substance, there is nothing to distinguish this corporation from innumerable others, whether they be devised to achieve a temporary tax reduction or some other legitimate end." E. F. Gregory, 27 B. T. A. 223, 225 (1932). Cf. also quotation from Bullen v. Wisconsin, *supra* note 8.

31. J. L. McInerney, 29 B. T. A. 1 (1933).

32. Nace Realty Co., 28 B. T. A. 467 (1933).

33. S. A. Macqueen Co. v. Commissioner of Internal Revenue, 67 F. (2d) 857 (C. C. A. 3rd, 1933).

34. M. I. Stewart & Co., 2 B. T. A. 737 (1925).

35. W. P. Fox & Sons, Inc., 15 B. T. A. 115 (1929).

language and relying upon the decisions to which we have animadverted above have ignored the separate personality of corporations and have levied taxes accordingly.[36]

But an equally imposing array of cases might be collected where the Board of Tax Appeals or the courts have refused, citing other cases, to disregard the corporate personality. Again, the mere enumeration of the situation reveals the conflict between the cases and the difficulties encountered in stating any guiding principle. For example, it has been held that where a corporation transfers its assets to a partnership composed of its stockholders, a taxable transaction results;[11] that the liquidation of a corporation which has only one stockholder may result in a gain to the stockholders;[37] that a corporation formed simply for convenience, without any profit motive whatsoever, is nevertheless an entity separate from its stockholders;[38] that the salary paid to a sole stockholder is a deductible item.[39] And there are many similar cases.[40]

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36. See, for example, Coudon v. Tait, 56 F. (2d) 208, 211 (D. C. Md. 1932), where the court said: "As the Delaware corporation is a mere holding company and a convenient conduit for the transfer of dividends from the operating and earning companies to the ultimate owners (the stockholders of the Delaware corporation), it would be legally possible, if necessary, to disregard the corporate fiction of the holding company in order that the obvious purpose of Congress to tax income from dividends in the ordinary form should be accomplished." See also Labrot v. Burnet, 57 F. (2d) 413 (App. D. C. 1932) (holding that the transfer of a farm by a partnership to a corporation of which the partners were the sole stockholders cannot result in a deductible loss); Industrial Cotton Mills v. Commissioner of Internal Revenue, 61 F. (2d) 291 (C. C. A. 4th, 1932) (holding that a loss sustained by a subsidiary before merger with the parent corporation is deductible by the merged corporation); H. H. Miller Industries v. Commissioner of Internal Revenue, 61 F. (2d) 412 (C. C. A. 6th, 1932) (holding that upon transfers of assets by one corporation to another identically owned and controlled, depreciation may be deducted from cost to first corporation); Michaels v. McLaughlin, 20 F. (2d) 959 (N. D. Cal. 1927) (holding that a bookkeeping transfer from profit and loss to capital in discharge of stockholder's obligation to corporation is not taxable income).

37. John K. Greenwood, 1 B. T. A. 291 (1925).

38. Waldron Co., 2 B. T. A. 715 (1925).

39. Max Levy & Co., 3 B. T. A. 422 (1926); International Building Co., 21 B. T. A. 617 (1930).

40. In Fruit Belt Telephone Co., 22 B. T. A. 440 (1931), the Board held that a sale by a corporation of all of its assets to its two sole stockholders and a resale on the same day by the stockholders to another corporation at a higher price was not in bad faith and did not give rise to the necessity of ignoring the corporate entity. We quote from p. 441: "A corporation may clearly do what it has a legal right to do, even for the sole purpose of reducing its tax liability. It is not required to pursue a course which gives rise to a greater tax liability if another course is open to it which gives rise to a less tax liability." See also Nixon v. Lucas, 42 F. (2d) 833 (C. C. A. 2d, 1930) (holding that partners who own all the stock of a corporation may not deduct losses incurred by the corporation of money loaned by the partners); Walker v. Gulf & Interstate Ry. Co. of Texas, 269 Fed. 885 (C. C. A. 5th, 1921) (holding that money advanced by a corporation to pay the operating loss of a subsidiary is not deductible); New York, Chicago & St. Louis Rr.

At this point it will no doubt be surmised by the legal technician that a close inspection of the cases might reveal bases for distinction between decisions that respect corporate entities and those that disregard them. And in truth this field of law is no exception to the general rule that the courts proceed by the method of exclusion and inclusion. Unfortunately the grounds for excluding a case from a stated rule or including it therein do not here lend themselves to scientific analysis.

For example, when the Supreme Court decided the case of *Weiss v. Stearn*,[14] it had before it the decisions in *United States v. Phellis*,[9] *Rockefeller v. United States*[41] and *Cullinan v. Walker*,[10] all of which were decided on a different theory from that pronounced in the case at bar. Only one paragraph is devoted to distinguishing the earlier decisions, and it reads as follows:

> "As the result of transactions disclosed in the *Phellis* and *Rockefeller Cases*, certain corporate assets not exceeding accumulated surplus were segregated and passed to individual stockholders. The value of the segregated thing so received was held to constitute taxable income. Cullinan's gain resulted from a dividend in liquidation actually distributed in the stock of a holding company incorporated under the laws of a foreign state, not organized for the purpose of carrying on the old business, and which held no title to the original assets."[42]

When these distinctions are closely analyzed, they disappear. Apparently the Court was of the opinion that upon the transfer of assets of one corporation to another the distribution of the securities of the new corporation to the stockholders of the old is taxable (a) if the assets transferred do not exceed the value of the accumulated surplus of the old corporation, and (b) where the new corporation is organized under the laws of a foreign state; for, contrary to the assertion of the court, the new corporations in the *Cullinan* case were in fact organized, not for the purpose of liquidation, but for carrying on the business of the old. But the distribution even of surplus in the form of stock to the stockholders of a corporation had already been held in *Eisner v. Macomber*[43] not to constitute income; and in these days, when the choice of a state for incorporation is so largely a matter of convenience, it is difficult to see

Co. v. Burnet, 64 F. (2d) 152 (App. D. C. 1933) (holding that a corporation formed to take over assets from a receiver of another by issuing its securities to the security holders of the old corporation is a separate entity from the old corporation); cf. Gramaphone and Typewriter, Ltd. v. Stanley, [1906] 2 K. B. 856, aff'd by the Court of Appeals, [1908] 2 K. B. 89 (holding that ownership of all stock of a German corporation by an English corporation does not make the business of the former part of the latter's business for purposes of income tax).

41. 257 U. S. 176 (1921).

42. 265 U. S. 242, 252 (1924).

43. 252 U. S. 189 (1920).

how a corporation organized under the laws of one state differs essentially from one organized under the laws of any other state.

When we read in the subsequent opinion of Mr. Justice Brandeis in *Marr v. United States*,[15] how he in turn distinguishes *Weiss v. Stearn*,[14] from which he had dissented, our view with regard to the triviality of these distinctions is reinforced. He says: "In *Weiss v. Stearn* a new corporation had, in fact, been organized to take over the assets and business of the old".[44] This of course is true in all of these cases. "Technically there was a new entity;"[44] but of course technically there always is a new entity. He continues:

"...but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same State, with presumably the same powers as the old. There was also no change in the character of securities issued. By reason of these facts, the proportional interest of the stockholder after the distribution of the new securities was deemed to be exactly the same as if the par value of the stock in the old corporation had been reduced, and five shares of reduced par value stock had been issued in place of every two shares of the old stock. Thus, in *Weiss v. Stearn*, as in *Eisner v. Macomber* the transaction was considered, in essence, an exchange of certificates representing the same interest, not an exchange of interests."[44]

In other words, the essential difference which is relied on by the court is that the two corporations in *Weiss v. Stearn* were formed under the laws of the same state, whereas in the prior cases they were formed under the laws of different states. That this distinction is without any substantial importance will, I think, be readily conceded. And yet, the court is compelled to emphasize the distinction, saying,

"In the case at bar, the new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these *inherent differences* in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new." (Italics ours).[45]

These "inherent differences" are apparently abandoned by the dissenting judges in the *Marr* case—the very same judges who created the distinction in *Weiss v. Stearn*. Here they maintain that that case "did not turn upon the relatively unimportant circumstances that the new and old corporations were organized under the laws of the same State."[46]

Again, in *Western Maryland Railway Company v. Commissioner of Internal Revenue*,[19] where the court disregarded corporate entities, it

44. Marr v. United States, 268 U. S. 536, 541 (1925).

45. Ibid.

46. Id. at 542.

was admitted that the new corporation "is a distinct legal entity from those whose places it has taken";[47] nevertheless the decision was supported because of the identity of management, assets and stockholders of the two corporations. Yet in *Turner-Farber-Love Company v. Helvering,*[20] where a contrary result was reached, a distinction was found by the court in the fact that the transfer of assets was here brought about by a legal transfer which left the old corporation still technically alive, whereas in the *Western Maryland* case, said the court, there was a consolidation of the two companies which destroyed the existence of the old corporation as a separate entity. In view of the fact that where one corporation is organized to take over the assets of another it is immaterial whether the two corporations are technically merged or whether the first transfers its assets to the second, this distinction would also seem to be without any important basis. In both cases, the new corporation steps into the shoes of the old by the same management, same stockholders and the same liabilities as well as the same assets. Only the legal form by which this is accomplished is different. Instead of choosing one legal device they choose another. Can this be said, in all seriousness, to supply a distinction upon which an important legal differentiation can be based?

In *Nixon v. Lucas,*[48] a corporation which was admittedly organized merely for convenience and used as a mere form, was regarded as a separate entity. Here the court stated it as a general rule that corporations are usually regarded as separate entities and said that, "The exceptions are those in which the persons charged, ignoring the constituted authorities of the corporation, transact the business themselves, though in its name", and added that if "a legal transaction arises between a company and those who control it, the relations ensuing are the same as between any other persons, if so intended."[49] Yet the Circuit Court of Appeals for the Third Circuit, in *S. A. Macqueen Company v. Commissioner of Internal Revenue,*[33] disregarded corporate entity where convenience was the cause of the transaction with the simple assertion that "the principle that substance and not form should control in the application of income tax law may be invoked in the instant case".[50]

It is perhaps needless to multiply illustrations of the resourcefulness of judicial craftsmanship. Distinguishing cases on the basis of adventitious facts does not lead to the establishment of rules or principles which can aid the treasury or the taxpayer in determining a course of conduct. It is clear beyond peradventure that no guiding principle can be stated which will explain even most of the cases. On the contrary,

47. 33 F. (2d) 695, 697 (C. C. A. 4th, 1929).
48. 42 F. (2d) 833 (C. C. A. 2d, 1930).
49. Id. at 834.
50. 67 F. (2d) 857, 858 (C. C. A. 3rd, 1933).

it might with confidence be stated that as far as a specific new problem is concerned, the prediction of the judicial attitude is entirely beyond the power of the legal mind.

II

When analysis fails, legal theorists frequently turn to psychology, but here we are obviously in a field where conjecture rather than certainty is the rule. For if we consider the decisions of the judges we find that frequently the same judge has concurred in opinions which involved diametrically opposite views with regard to the corporate entity. For example, in *Burnet v. Commonwealth Improvement Company*,[10] a comparatively recent case, the entire court concurred in an opinion which emphatically stressed the separate personality of a corporation and its sole stockholder and proceeded to impose a tax on the basis thereof. Yet Mr. Justice McReynolds and Mr. Justice Brandeis, who were members of the Court and concurred in that decision, also concurred in the opinion in *Gulf Oil Company v. Lewellyn*[23] which relieved the taxpayer of a tax liability in a very similar situation by ignoring the separate entity of a corporation. And in the last named case, Mr. Justice Clarke concurred with the majority though he dissented from a similar decision in an almost identical case previously decided: *Southern Pacific Railway Company v. Lowe.*[22] In *Rockefeller v. United States*[41] only Mr. Justice McReynolds and Mr. Justice VanDevanter dissented from the opinion which respected separate corporate entities, but in *Cullinan v. Walker*[10] they joined with the majority which followed the *Rockefeller* case. On the other hand, in *Weiss v. Stearn*,[14] where the majority disregarded the corporate entity, only Justices Holmes and Brandeis dissented; and the opinion of the majority was concurred in by Justices Taft, McKenna, VanDevanter, McReynolds, Sutherland, Butler and Sanford. In *Marr v. United States*,[15] *Weiss v. Stearn* was not followed; yet Justices Taft and McKenna were still joined with the majority, this time in insisting upon a corporate entity. It would seem therefore, that after the decision in *Cullinan v. Walker*,[16] only Justices McReynolds and VanDevanter maintained consistently the position that corporate entities should be disregarded in this class of cases. But of course even these two Justices, as we have seen, did not hold this view in *Cullinan v. Walker*;[10] moreover, they both joined the majority in the most recent case, *Burnet v. Commonwealth Improvement Company*,[10] where the Supreme Court unanimously upheld the doctrine of the separate corporate entity in a case involving a transaction between a corporation and its sole stockholder.

It is plain, therefore, that one would have to go beyond the four corners of judicial opinions to discover a psychological explanation of the judicial line-up in these cases, a task which mere students of law are probably not competent to undertake.

Occasionally a forceful judge with a penchant for logical statement will reveal in his opinions the difficulties encountered in this situation. Such a one is Judge Learned Hand. There are times when reading his opinions would lead the unwary to conclude that he favors as a guiding principle the desirability of collecting the federal income tax. For example, he refused to follow the decision of the Supreme Court of the United States in *Southern Pacific Railway Company v. Lowe*[22] that dividends paid by a wholly owned subsidiary are not taxable as income to the parent corporation, although he admitted that "ordinarily we should assume that a decision of the Supreme Court, so similar upon the facts, laid down a rule of general application, even though the court itself declared that it turned 'upon its very peculiar facts' ".[51] But in the same case he insisted upon the separate entity of a corporation which had, as he said, "only a formal existence, all its transactions being in fact determined by the parent, which kept it alive for reasons of accounting and the like; though the form was consistently observed, both in the books, and by means of a dummy board of directors."[51] He concurred in the opinion in *Harwood v. Eaton*,[52] which held that a corporation is taxable when it leases its property under a lease which provided for the payment of the rent directly to the stockholders, but found it necessary to state in a separate opinion that "a corporation is not distinct from its shareholders in such a situation as this"[53] and to add, after discussing the unsatisfactory state of the law on this point: "This being the setting, we do no violence to language, if we say that the payments, though made directly to each shareholder, were payments to the associates as a group; and that they are identified with the corporation, so far as it must be construed as having an independent personality, a vexed question at best."[54] He held that a tax resulted in a case where a corporation was formed solely for the purpose of evading the tax,[1] but here found it necessary to say with regard to the problem of the separate corporate entity that he disagreed with the manner in which the Commissioner below had disregarded it and that the corporation, though formed in order to evade taxation, "had a juristic personality, whatever the purpose of its organization."[55] In *United States v. Rockefeller*,[12] he insisted upon the separate entity of corporations and collected a tax, escaping contrary decisions by suggesting diversity of purpose between the two corporations

51. Nixon v. Lucas, 42 F. (2d) 833, 835 (C. C. A. 2d, 1930).
52. 68 F. (2d) 12 (C. C. A. 2d, 1933).
53. Id. at 14.
54. Id. at 15.
55. Helvering v. Gregory, 69 F. (2d) 809, 811 (C. C. A. 2d, 1934).

as a basis for separate corporate personalities, and disregarding common stockholding and control. We find that he even dissented from his brethren in the Circuit Court when they held with the taxpayer in an income tax case and supported his dissent by an apparent confusion between an option and a privilege though he admitted that the case was a "hard one".[56]

If from these illustrations we conclude that Judge Learned Hand proposed to collect the income tax and to disregard or insist upon the corporate entity whichever may be necessary for the purpose, we are perhaps, to paraphrase his own opinion, not doing violence to the process of legal induction. That he has not had the same attitude with regard to other kinds of taxes appears not only from *Proctor & Gamble Company v. Newton,*[7] in which he allowed a corporation to escape a *state* tax though it was controlled by a parent corporation, on the unsubstantial ground that its officers were chosen by its own board, though the board was controlled by the parent corporation, but also from an older case dealing with the old federal excise tax, *United States v. Oregon-Washington Railroad & Navigation Company,*[57] where he held that forgiveness of a debt by a sole stockholder of a corporation to the corporation did not constitute income within the meaning of that tax law.

III

The difficulty of finding a consistent and satisfactory rule in the cases, leaves us with the problem of suggesting an approach which will produce the necessary predictability so essential to fairness in taxation and at the same time avoid the sacrifice of governmental revenue to be derived from the income tax. Some limited assistance to the attainment of these ends, it is true, might be secured through purely administrative measures. Thus the treasury might adopt the policy of advising taxpayers in advance of the formulation of a plan as to its attitude with regard thereto. If this practice were adopted, an honest taxpayer who contemplated the organization of one or more corporations in connection with the conduct of his business could secure a considerable degree of the assurance which he seeks, by ascertaining in advance whether in the view of the treasury the new corporate entities would be disregarded or recognized.

But even if the treasury were to adopt this practice, we would still be very far from a solution. In the first place, since no adequate criterion has been suggested by which to measure corporate entities, the

56. Patent Royalties Corporation v. Commissioner of Internal Revenue, 65 F. (2d) 580, 582 (C. C. A. 2d, 1933).

57. 251 Fed. 211 (C. C. A. 2d, 1918).

decisions of the treasury in advance of the adoption of a plan would necessarily be as arbitrary as they are now when they are made after its adoption. Again, such advance rulings might have a strong tendency to discourage commercial activity in many cases, and thus to cause a loss of revenue to the government; for the treasury might well reject many plans which tax experts would have approved. On the other hand, courageous taxpayers, hoping to upset treasury rulings by judicial review, would often proceed in disregard of treasury advice and adopt plans which the treasury had held taxable; and in this event there would be no improvement over present practice. Most serious of all, it is very likely that the necessity of passing on all plans will be a far greater strain on the administrative machinery of the treasury than it can readily bear. These considerations make it plain that the rendition of treasury rulings in advance of the adoption of plans would be at best a limited expedient. The essential problem with regard to corporate entity still remains, and we are still confronted with the task of discovering a basis for judgment in this class of cases. What is needed is a fundamental principle which can be embodied either in legislation or in judicial decisions and which will be applicable to the vast majority of cases which come before the courts and which involve the problem of determining whether a particular corporation is to be treated as a separate entity or merely as the extension of an already existing juristic personality.

Of course, the position which we have found implicit in the opinions of Judge Learned Hand—to resolve all doubtful cases in favor of the government—would, in a sense, circumvent this necessity. And whether or not we have correctly analyzed Judge Hand's opinions, a strong case has been stated in support of that view. To be sure, if all doubtful cases resulted in the imposition of the income tax regardless of technical considerations and without benefit of rigid general rules for dealing with the problem of corporate entity, the taxpayers would soon learn the futility of attempting to evolve fine-spun, hair-splitting devices. Diversity among the decisions would certainly tend to be considerably lessened in practical result, if not in juristic reasoning. Taxpayers would no doubt find by repeated experiences that the more involved and complicated the plan, the greater the likelihood of taxation. And while in the past the rule has been enunciated by the courts that all doubts are to be resolved in favor of the taxpayer,[58] this in and of itself is no reason why a contrary rule should not be adopted if it can be shown to be serviceable and to provide a more efficient system of tax collection. Nor can it be denied that the primary purpose and function of a system of

58. Gould v. Gould, 245 U. S. 151, 153 (1917); Hecht v. Malley, 265 U. S. 144, 156 (1924).

taxation is not to provide abstract rules and symmetrical principles, but to provide abundant revenue.

But, despite its practical conveniences and justifications, the suggestion has its dangers and difficulties, its elements of unfairness and even of uncertainty. It must be remembered that while it is a primary purpose of the Income Tax Law to collect the needed governmental revenue, it is and should be an equally important purpose of that law that the burden of the income tax shall fall equally and fairly upon all taxpayers in accordance with their earnings over a particular period and without unnecessary harshness. To assume with Draconian severity that in all doubtful cases the tax should be imposed is to ignore this second and equally important purpose of the Income Tax Law. It is almost equivalent to saying to a taxpayer that he must pay the income tax not only if he has had the income but even if there is a doubt, a fair and reasonable doubt, as to whether he has had the income. The very fact that the case is doubtful means that it is possible that the taxpayer should have been exempted from the tax, and the uniform imposition of the tax in every one of those cases would be grossly unfair. If the governmental revenue from the income tax is not sufficient, more direct equitable and scientific ways can surely be found for increasing it, without resorting to what must at best be looked upon by the taxpayers as a subterfuge in governmental administration of the tax law.

Moreover, the suggestion that the Government tax all doubtful cases raises another and equally difficult question. What is a doubtful case? That in itself may become the subject of great debate and uncertainty. The scientists tell us that the universe is finite. It may be larger or smaller than our measurements presently indicate, but it has an end. Tax situations do not, however, end so completely; and borderline cases cannot be eliminated by extending the borderline beyond its present position. Very frequently what is too clear for argument to one jurist is a matter of grave doubt to another and often provides the very issue upon which courts divide.[59]

Another possibility would be the adoption of the test enunciated by the Board of Tax Appeals in *George H. Chisholm*,[29] namely, that recognition as a separate legal entity for taxation purposes should be accorded only to those business units organized in the course of normal business or made necessary by ordinary business convenience. Should it turn out that it is possible to apply such a rule it would certainly

59. The rule that a statute which is clear in its terms precludes resort to extrinsic evidence of its intent affords some analogy, as Mr. Justice McKenna remarked in his dissent in the Caminetti case, 242 U. S. 470, 496 (1917): "The principle has attractive and seemingly disposing simplicity, but that it is not easy of application or, at least, encounters other principles, many cases demonstrate."

seem to contain all the elements of fairness of which we have already spoken. It seems to divide all corporations into two mutually exclusive classes, the normal and convenient, and the unusual and unnecessary. It is possible that the situation we are discussing is of such a nature that only a norm of this kind can be evolved. But it is difficult to rid oneself of the feeling that the suggested solution is too vague and uncertain to be useful. Business convenience and business custom are extremely nebulous concepts. What may appear as normal and convenient to one group of business men will appear entirely the other way to another group. The determination must be based upon a judgment to be made in the light of certain facts. Frequently the success or failure of a particular enterprise depends upon the soundness of this very judgment. If all men were like-minded, this solution would indeed be one of the simplest. But conditions being what they are, it is difficult to imagine business men agreeing even generally on questions of this character, and it is even more difficult to imagine the courts and the taxing officials having harmonious views with regard to business convenience. Nor, in view of the infinite variety of particular business situations, as well as the variety of business judgments, is it practical to look for a mythical "normal" course of conduct. In the end, every case would depend for its solution on the arbitrary judgment of the courts as to whether a particular course of conduct was normal and convenient under all the circumstances. Such judgment could only be made by appeals to the commercial experience of a particular judge or set of judges and would lead us directly to a sort of judicial solipsism, to the importation of the "inarticulate major premise" into income tax cases. A formal consistency might be attained in the decisions, but it would mask a state of the law as unpredictable and confused as that which obtains at present.

Inadequate as the foregoing test must be considered, nevertheless the case which enunciated it contained language and embodied a point of view which suggest a considerably more promising approach. The specific test adopted was an objective one, yet the Board of Tax Appeals was obviously attempting to formulate a standard which would take the taxpayer's motive into account. In this direction, it would seem, lies a possible solution of at least part of this vexing problem. The courts might adopt the rule that all corporations which are formed or are being used chiefly for the purpose of avoiding taxation should not be regarded as separate entities and that only those corporations be considered as separate personalities which were formed or were used for purposes other than the avoidance of taxation. It is of course perfectly clear that the problem of determining the dominant purpose of the formation or use of a corporation is not always an easy one, that it requires careful investigation and a detailed knowledge of all the facts and circumstances surrounding a particular case. Yet experience has taught us that it is comparatively simple to conduct the necessary investigation and to find the motive of the taxpayer writ large in the plans he has adopted and in the manner of their execution. To discover the dominant purpose for the formation of a corporation is to make a determination with regard to a fairly precise fact. On the other hand, to investigate whether a corporation was formed in the ordinary course of convenient business practice is to delve into the realms of conjecture, to attempt to apply vague and elastic criteria of judgment to varying states of fact. The former is infrequently controvertible. The latter is nearly always the subject of discussion and debate and a matter about which satisfactory conclusions can seldom be definitely formed.

We are aware of the great difficulties that are involved in this suggestion. It necessitates a radical departure not only from existing judicial precedents, but from the existing spirit of income tax legislation itself. We have seen that the courts have refused to say that the formation of a corporation for the sole purpose of avoiding income tax is ground for disregarding its corporate personality.[30] In the same way, the Income Tax Law itself has recognized the right to create corporations for the purpose of avoiding income tax levies. Thus the law permits an individual to transfer his property to a corporation of which he becomes the owner of all the stock without incurring any tax liability therefor.[60] In this way, many taxpayers are able to escape the imposition of very heavy surtaxes. Legislative permission for the filing of consolidated reports by two or more corporations is another illustration—this time of the legal sanction for disregarding corporate entities, to avoid income tax.[5] Yet despite these judicial obstacles, and legislative exceptions, it seems to us that this test of dominant purpose is the closest approximation to a working rule that has thus far been suggested. It would involve a reversal of the existing judicial attitude, but at the same time it would give to the treasury a fixed principle with which to operate in cases involving corporate personality. The determination of motive, moreover, is a question of fact; and if not entirely devoid of supporting evidence, the administrative ruling would not be subject to judicial review. To be sure, it is not plain that a solution can thus easily be arrived at in *every* case. There will always remain doubtful cases where the closest scrutiny and the fullest familiarity with facts will not be able to reveal the true purposes of the taxpayer's plan, and there is always a certain latitude of doubt where motives of various kinds coexist; but in practice these difficulties are not so formidable.

60. See Income Tax Act of 1932, Sec. 112 (5), 47 STAT. 196, 26 U. S. C. A. § 3112 (1932).

There are few secrets between the treasury and the taxpayer, and the dominant purposes of the latter in all plans that he adopts do not long remain a mystery to administrative officials. In a word, it seems possible that the quantity of uncertainty under this criterion may prove to be smaller than under the other proposals.

That law contains a large amount of uncertainty has long been recognized by commentators. It derives in the various branches of legal science from different sources. In constitutional law, our studies of due process have led to the conclusion that the personality of the judges is often the variable factor.[61] In tort cases, the inherent difficulty of applying a standard of judgment to constantly changing factual situations gives rise to the difficulty.[62] In the cases we have referred to in this article, our inability to formulate a serviceable rule or a guiding principle, is the basis of the evil. In the end, the administration of justice in all of these cases becomes an individual matter, and the efficiency of our system can be tested only by analyzing the results of a particular rule over a given period. We must always bear in mind that the efficient collection of taxes dictates the promulgation of rules easily applicable to varieties of situations and at least a rough pragmatic logic, easily comprehensible by lawyers and laymen alike.[63]

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61. Powell, *The Judiciality of Minimum-Wage Legislation* (1924) 37 HARV. L. REV. 545, 546. "Until some due-process issue is authoritatively settled, one who would make a constitutional prophecy or a constitutional argument should be familiar with the outlook and the temper of the judges by whom the issue is to be decided."

62. Pound, *The Administrative Application of Legal Standards* (1919) 44 A. B. A. REP. 445, 458-459.

63. After this article went to press, the Supreme Court of the United States decided the case of Gregory v. Helvering, (1935) 2 U. S. L. Week 29, Col. 2, in which the Court recognized the rule that the motive of the taxpayer in forming a corporation is not to be considered in determining income tax liability. In that case it was held that the corporation must be formed for a corporate or business purpose in order to be considered as a party to a reorganization: "When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' (Sec. 112 (g)) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner."